Chapman and Cutler LLP

Chapman Client Alert

November 27, 2019 Current Issues Relevant to Our Clients

SEC Proposes Modernized Rules for the Use of Derivatives by Registered Investment Companies

On November 25, 2019, the Securities and Exchange Commission (the "SEC") re-proposed Rule 18f-4 ("Rule 18f-4") under the Investment Company Act of 1940 as amended (the "1940 Act"). Rule 18f-4 is intended to be a new exemptive rule that is designed to enhance the regulation of the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and business development companies ("BDCs") notwithstanding the restrictions under the 1940 Act.

The 1940 Act limits the ability of registered funds and BDCs to use leverage, including by engaging in transactions that involve potential future payment obligations. Although leverage is commonly achieved by borrowing funds, derivatives, such as forwards, futures, swaps and options, also create future payment obligations. Rule 18f-4 would permit registered funds to use derivatives that create these obligations, provided that the funds comply with certain conditions designed to protect investors.

As part of the proposal, the SEC proposed new sales practice rules, Rule 15l-2 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Rule 211(h)-1 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") designed to address specific considerations raised by certain leveraged or inverse funds and exchange-listed commodity or currency pools.

Proposed Rule 18f-4

Proposed Rule 18f-4 is similar in scope to the SEC's 2015 rule proposal. Two notable differences are that, unlike the 2015 proposal, the proposed rule does not contain any notional cap limitations or asset segregation provisions. However, Rule 18f-4 sets limits on leverage, based on a value-at-risk ("VaR") calculation, which compares the fund's risk level to a designated reference index. Funds would not be permitted to exceed 150% of the reference index's VaR-based exposure. If a fund's Derivatives Risk Manager (explained further below) is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed 15% of the value of the fund's net assets.

Proposed Rule 18f-4 also would require a fund to implement a written derivatives risk management program (the "Risk Management Program"). The Risk Management Program would institute a standardized risk management framework for funds, while requiring "principles-based" tailoring by each fund to the fund's particular risks. The Risk Management Program would have to include risk guidelines as well as stress testing, back-testing, internal reporting and escalation, and program review elements. To administer the Risk Management Program, a fund's board of directors will also have to approve a Derivatives Risk Manager who will report to the fund's board on the Risk Management Program's implementation and effectiveness to facilitate the board's oversight of the fund.

Proposed Rule 18f-4 would provide an exception to the Risk Management Program requirement and the VaR-based limit on fund leverage risk for a fund that either: (a) limits its derivatives exposure to 10% of its net assets, or (b) uses derivatives only to hedge certain currency risks. In addition, proposed Rule 18f-4 would permit a fund to enter into reverse repurchase agreements and similar financing transactions, subject to certain conditions.

Leveraged and Inverse Funds

Registered investment companies that seek to provide leveraged or inverse exposure to an underlying index—including leveraged ETFs—would not be subject to the proposed limit on fund leverage described above but instead would be subject to alternative requirements under the SEC's proposal. The SEC recognizes that most leveraged/inverse funds could not satisfy the limit on fund leverage risk in proposed Rule 18f-4 because they provide leveraged or inverse market exposure exceeding 150% of the return or inverse return of the relevant index. These highly leveraged funds (a) would have to limit the investment results they seek to 300% of the return (or inverse of the return) of their underlying index (i.e., three times leveraged), (b) would have to disclose in their prospectus that they are not subject to the proposed limit on fund leverage risk, and (c) the sales of these funds would be subject to proposed new sales practices rules discussed below.

Filing Requirements

The proposals would also require funds to confidentially report any instances in which it breached its VaR-based limit on fund leverage risk for more than three consecutive business days. The fund would be required to file the same form with the SEC as it would for violations of the liquidity risk management rule, which went into effect in June 2019. Form N-LIQUID will be renamed “Form N-RN” as part of the expansion of the form’s use.

Sales Practice Enhancements for Highly Leveraged Funds

The SEC’s Office of Investor Education and Advocacy and FINRA have issued alerts over the past decade to highlight issues investors should consider when investing in leveraged or inverse funds. Some commenters to the SEC’s 2015 proposal indicated that at least some segment of investors may hold leveraged or inverse funds for long periods of time, which can lead to significant losses.

In connection with the proposed new rules, the staff of the SEC’s Division of Economic and Risk Analysis composed a note which concluded that the distribution of leveraged ETF returns becomes more skewed as their leverage multiple increases: the likelihood of experiencing losses from a long-term investment in a leveraged fund increases, while the magnitude of potential gains, when they do occur, also increases. These features of leveraged ETF returns are similar to those of options, whose skewedness increases with the extent to which an option is out of the money. The staff equated the need for a higher level of investor sophistication to understand the return characteristics of options to that of leveraged ETFs over longer holding periods and noted that while a broker-dealer accepting a customer’s order for options is subject to FINRA account approval and due diligence requirements under FINRA Rule 2360(b)(16), similar requirements for transactions in leveraged ETFs currently do not exist.

Under the proposed sales practice rules, Rule 15l-2 under the Exchange Act and Rule 211(h)-1 under the Advisers Act, a broker-dealer or an SEC-registered investment adviser (or an adviser required to be registered with the SEC) would have to exercise due diligence in approving a retail customer or client’s account to buy or sell shares of funds not meeting the VaR-based limit, as well as shares of exchange-listed commodity or currency pools that have similar investment strategies. A broker-dealer or investment adviser could only approve the purchase if it had a reasonable basis to believe that the customer or client is capable of evaluating the risks associated with these products. These proposed rules are intended to help ensure that retail investors in these leveraged products are limited to persons who are capable of evaluating the products’ characteristics, including that the funds would not be subject to all of the leverage-related requirements under the proposed rule applicable to registered investment companies generally, and the unique risks they present.

Amendments to Rule 6c-11

The proposed rules include provisions relating sales practices rules under the Exchange Act and the Advisers Act that would create a more comprehensive regulatory framework applicable to the sale of leveraged/inverse ETFs. In light of these updates, the SEC is proposing to amend Rule 6c-11 under the 1940 Act to remove the provision excluding leveraged/inverse ETFs from the scope of that rule one year following its enactment. In addition, because the proposed amendments to Rule 6c-11 would permit leveraged/inverse ETFs to rely on that rule rather than their exemptive orders, the proposed rules would rescind the exemptive orders previously issued to leveraged/inverse ETFs. The exemptive relief granted to leveraged/inverse ETFs has resulted in an uneven playing-field among market participants because the SEC has permitted only three ETF sponsors to operate leveraged/inverse ETFs and has not granted any exemptive relief for leveraged/inverse ETFs since 2009.

Comment Period

The new proposal will be published on SEC.gov and in the Federal Register. The public comment period will remain open for 60 days after publication in the Federal Register.

We will provide a more in-depth analysis moving forward.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management group, or visit us online at chapman.com.

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